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SUBJECT: SACA'S 2006 BUDGET APPROVED ON TIME

11. (U) Summary. On December 21, 2005, the Legislative Assembly approved President Saca's \$3.3 billion budget proposal for 2006--an 11.6 percent increase over the previous year--to cover higher spending on health and education, pensions, public-sector salaries, and debt payment. The fiscal deficit for 2006 will reach \$458.1 million, 2.7 percent of GDP, and public debt will rise slightly to \$7,198.2, 40.8 percent of GDP, as spending increases slightly outpace projected increases in tax collection. The budget was approved with the support of ARENA, the PCN, and the G-14--a new coalition of left leaning deputies--after the government agreed to G-14 demands on pension funding, municipal debt, and mechanisms to prevent evasion of local taxes. Legislative approval prior to the start of the January-December fiscal year will help avoid detrimental delays in expenditure as in previous years. End summary.

12. (U) On December 21, 2005, the Legislative Assembly approved President Saca's \$3.3 billion budget proposal for 2006, an 11.6 percent increase over the previous year. The Ministry of Education's budget increases by 5.6 percent over the 2004 budget to \$510.7 million (2.9 percent of GDP). The government will continue strengthening the quality and scope of the education system through the implementation of Plan 2021, as well as increase teacher salaries (see para. 7). Spending on grades 1-6 increases by 12.1 percent, and at \$309 million, spending for these grades is 60.1 percent of the Ministry's budget. Two World Bank loans used to fund construction of new school buildings were almost completely disbursed in 2005, and investment in educational infrastructure will fall from \$48.3 in 2005 to \$21.8 million in 2006.

13. (U) The budget for the Ministry of Public Health increases by nearly 13.6 percent to \$313.1 million (1.8 percent of GDP). Healthcare spending goes toward improving the free care provided at national hospitals and toward continued efforts to rebuild hospitals and other healthcare infrastructure damaged by the earthquakes in 2001. Meanwhile, the Solidarity Fund for Health (FOSALUD) a \$20 million off-budget program funded by a tax on alcohol, fireworks, and firearms--supports local health clinics in underserved areas.

14. (U) The Ministry of Tourism sees its budget increase from \$0.2 million in 2005 to \$5.8 million in 2006. The increase includes support for the Salvadoran Tourism Institute (\$2.4 million) and the Salvadoran Tourism Corporation (\$3.2 million), both of which were previously funded through the ministry of Economy. Tourism Minister Ruben Rochi plans to finish the reconstruction of two popular tourism centers damaged during the earthquakes and plans to revitalize the Port of La Libertad. The Ministry of Economy budget is \$46.1 million, a 12.7 percent increase over 2004. Efforts to establish a new Consumer Protection Office receive \$1.3 million in funding, while \$6.5 million is devoted to update economic and social statistics at the Census and Statistics Office (DIGESTYC). The budget increase will also support the creation of the new Superintendency of Competition and a special trust fund for the creation of employment in strategic productive sectors. The Ministries of Finance, Defense, and Labor also experience slight budget increases.

15. (U) The Ministry of Agriculture's budget holds steady at \$35.6 million, while the Ministries of Environment, Foreign Affairs, and Public Works experience cuts of \$5.9 million, \$12.4 million, and \$14.6 million, respectively. The Governance Ministry, which runs the country's police force, has capital expenditure cut by \$10.3 million, falling to only \$5.5 million, and overall spending cut by 8.9 percent to \$187.3 million. The budgets of the Human Rights Offices and the Attorney General remain unchanged. The Judiciary sees a \$16.7 million increase in funding for capital projects--including the construction of several courthouses and prisons--and an overall budget increase of 18.5 percent to \$160.9 million.

16. (U) Transportation infrastructure, such as road maintenance and construction, is allocated \$126.3 million.

A separate Fund for Road Construction and Maintenance (FOVIAL), funded by a gas tax, contributes \$67.5 million to this total, down 7.8 percent from 2005 thanks to higher fuel prices (and less driving). The government is also funding reconstruction and mitigation works to rebuild from Hurricane Stan and the Llamatepec volcano eruption, but budget figures for this effort are not yet available. Transfers to municipalities, by law fixed at 7 percent of the total budget, grow by 12.7 percent or \$18.2 million, to reach \$161.5 million.

17. (U) The budget includes a salary increase for public sector employees that costs the government \$40 million. After 8 years without a raise, those employees who earn \$400/month or less get a 10 percent raise; between \$401 and \$700, 8 percent; between \$701 and \$1,000, 7 percent; and for those earning above \$1,000/month, 3 percent. Teachers hired on an hourly basis see their rate increase by 9 percent. The President, Ministers, and agency heads receive no raise. Pension costs for 2006 reach \$400 million, a 13.3 percent increase over 2004, for pensions of employees under the previous public pensions system.

18. (U) Tax revenues jumped from \$1.857 billion in 2004 to \$2.162 billion in 2005, a 16.4 percent increase over 2004 collections. It also represents a 5.5 percent increase over what the government projected in the 2005 budget (\$111.8 million above projections). Gross tax collections were approximately 13.2 percent of GDP. Some tax reforms passed in 2005, including measures aimed at reducing tax evasion, went into effect January 1, 2006, and tax collection for 2006 is forecast at \$2.3 billion, a 10.3 percent increase over the 2005 budget. For 2006, taxes finance 68 percent of the budget. The largest source of revenue is the 13 percent value-added tax (VAT), which provides \$1,244.2 million, 55.1 percent of all taxes collected. Income tax is the second-largest source of tax revenue, providing \$734.1 million, or 32.5 percent of the total. With CAFTA implementation, import duties fall by 15.5 percent to \$177 million, contributing only 7.8 percent of total tax revenues. Other taxes contribute \$100.8, 4.5 percent of the total.

19. (U) The fiscal deficit for 2006 is forecast at \$458.1 million, 2.5 percent of GDP; in 2005, the deficit was 4.7 percent of GDP. The deficit will be financed with the sale of \$663.7 in bonds and \$183.1 million in loans from the Inter-American Development Bank, World Bank, Central American Bank for Reconstruction, and Government of Taiwan (\$600,000). The cost of the privatization of the pensions system is included as a separate category in the budget and will grow from 2.1 percent of GDP in 2005 to 2.3 percent of GDP in 2006, reaching \$400 million, \$46.9 million above the 2005 outlay. Consolidated public debt in 2006 will increase by \$458.1 million to \$6,990.3 million, or 39.6 percent of GDP. The nonfinancial public sector debt will rise to \$7,198.2, 40.8 percent of GDP, up from \$6,721.7 million in 2005, a \$476.5 million increase. The budget is based on a real GDP growth rate of 3-4 percent, at the high end of most forecasts for 2006, and an inflation rate of 2.5 percent. [Comment: If growth does not meet expectations, additional debt issuance (rather than spending cuts) is likely. End comment.]

110. (U) The budget was approved with the support of ARENA, the PCN, and the G-14; the left-leaning deputies of the Revolutionary Democratic Front (FDR), Democratic Change (CD), and the Christian Popular Social Party (PPSC) comprise the G-14, while the FDR includes several former FMLN deputies who last year voted for the budget and were expelled as a result. The FMLN did not vote in favor of the budget--the party's leadership had conditioned budget approval on the return to the colon (currency) and a 30 percent salary increase for government employees, among other things.

111. (U) In exchange for approval of the budget (simple majority) and related financing (super majority), the G-14 requested and received a pension increase for retired workers not covered by the new private system and increased municipal control of tax revenues and local debt. On pension funding, the Legislative Assembly sent a letter to the Ministry of Finance recommending that the 2007 budget increase pensions by 6 percent for those who receive \$114 or less and 3 percent for those who receive more. The Ministry of Finance also agreed to establish a nonpartisan technical commission on pension funding and government debt.

112. (U) The G-14 also pushed through a law allowing municipalities to borrow on their own behalf using central government transfers as collateral. The law limits the municipalities' debt to less than 1.7 percent of their operational revenues.

113. (SBU) Comment: The 2006 budget is the first in three years to be approved by January 1, the start of the fiscal year. The 2005 and 2004 budgets were delayed because the

FMLN had made unrealistic demands in exchange for support, similar to those made this year. In both cases, FMLN defectors broke the stalemate, and the budget went through. This year, with the FMLN having made itself irrelevant by kicking moderates out of the party, the GOES found itself negotiating with the G-14 for budget approval (support from the conservative PCN is a given). Negotiations were civil and for the most part conducted behind closed doors, but one senior GOES official told emboffs that dealing with the FDR was more difficult than with the FMLN. The rub for this GOES official may have been unfamiliarity in participating in actual give-and-take negotiations, rather than the all-or-nothing approach used with the FMLN.

¶14. (U) Comment Continued: Despite real progress on tax collection, the government is still borrowing heavily. Higher oil prices have no doubt had a significant impact. We are impressed the government has again followed through on its commitment to increase spending on health and education, no doubt influenced by a desire to remain eligible for MCC funding. If implemented, and in previous years that has been an issue, this is a pro-growth budget. End comment.

¶15. Table I. Government Budgeted Expenditures (millions of dollars)

	2005	2006	% change
Legislative Branch	22.8	23.8	4.4
Judicial Branch	135.8	160.9	18.5
Executive Branch	1,466.6	1,504.3	2.6
President's Office	61.5	62.7	2.0
Ministries	1,405.1	1,441.6	2.6
Finance	48.5	49.6	2.3
Foreign Affairs	43.6	31.2	-28.4
Governance	196.2	187.3	-4.5
Defense	106.0	106.4	0.4
Education	483.4	510.7	5.6
Public Health	275.5	313.1	13.6
Labor	7.0	8.6	22.9
Economy	36.9	41.6	12.7
Agriculture	35.6	35.6	0.0
Public Works	158.6	144.0	-9.2
Environment	13.6	7.7	-43.4
Tourism	0.2	5.8	2,800.0
Other Institutions			
Comptroller	20.3	24.2	19.2
Elections Council	11.1	9.8	-11.7
Civil Service	0.2	0.3	50.0
National Judicial Council	3.9	3.9	0.0
Human Rights Office	4.2	4.2	0.0
Attorney General	19.4	19.4	0.0
Public Defenders Office	17.1	15.5	-9.4
Public Debt	587.3	779.9	32.8
State General Obligations	474.5	483.5	1.9
Various Transfers	228.8	308.3	34.7
FOVIAL: Road construction/ maintenance	73.2	67.5	-7.8
FOSALUD: Health care	NA	20.00	NA
Total	2,992.0	3,338.0	11.6

¶16. Table II. Government Anticipated Tax Revenue (millions of dollars)

	2005	2006	% change
¶A. Income tax	640.1	734.1	14.7
¶B. VAT	1,093.1	1,224.2	13.8
¶C. Import duties	209.4	177.0	-15.5
¶D. Other	105.0	100.8	-4.0
Total tax revenue	2,047.6	2,256.1	10.2

Source: Ministry of Finance

Barclay